

## Message Text

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R 090942Z MAR 77  
FM AMEMBASSY LONDON  
TO TREASURY DEPT WASHDC  
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INFO AMEMBASSY BONN  
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DEPARTMENT PASS FEDERAL RESERVE BOARD

E.O. 11652: N/A  
TAGS: EFIN UK  
SUBJECT: NIESR REPORT ON U.K. ECONOMIC OUTLOOK

REFS: (A) LONDON 3534; (B) LONDON 19467, 1976

SUMMARY: THE NATIONAL INSTITUTE OF ECONOMIC AND SOCIAL RESEARCH (NIESR) HAS PUBLISHED ITS FEBRUARY FORECASTS AND APPRAISAL OF THE U.K. ECONOMY. THE FORECASTS OF SEVERAL VARIABLES HAVE BEEN SHARPLY REVISED FROM THE PREVIOUS NOVEMBER EXERCISE ALTHOUGH THE OVERALL TONE OF THE FORECASTS. THE BALANCE OF PAYMENTS OPTIMISM IN PARTICULAR REMAINS INTACT. NIESR EXPRESSES ITS RESERVATION OF SOME UNCLASSIFIED

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POINTS OF CURRENT ECONOMIC POLICY. BUT FEELS THAT THE GOVERNMENT IS LOCKED IN TO DIFFICULT CHOICES BETWEEN INFLATION AND UNEMPLOYMENT BY CIRCUMSTANCES AS WELL AS BY ITS OWN DESIGN. THE REPORT'S CONCLUSIONS CAN BE SUMMARIZED AS FOLLOWS:

SUMMARY OF THE FORECAST

ON UNCHANGED POLICIES  
1976 1977 1978  
REAL GDP (PERCENT CHANGE, YEAR/YEAR) 0.9 0.9 1.3  
REAL PERSONAL DISPOSABLE INCOME  
(PERCENT CHANGE, YEAR/YEAR) -1.5 -2.8 1.8  
UNEMPLOYMENT(A) (FOURTH QUARTER,  
MILLION) 1.3 1.5 1.6  
MONEY SUPPLY (M3, PERCENT CHANGE,  
END-YEAR) 12.1 11.1 8.3  
CONSUMER PRICES (PERCENT CHANGE,  
YEAR/YEAR) 15.6 14.2 8.3  
CURRENT ACCOUNT BALANCE (YEAR,  
POUNDS BILLION) -1.5 0.4 2.2  
EXCHANGE RATE (FOURTH QUARTER.  
\$ PER POUND)(B) 1.65 1.72 1.77  
PUBLIC SECTOR BORROWING REQUIREMENT  
(FISCAL YEAR, POUNDS BILLION) 10.4 7.7 5.6  
(A) - GREAT BRITAIN. SEASONALLY ADJUSTED, WHOLLY UNEM-  
PLOYED, EXCLUDING SCHOOL LEAVERS AND ADULT STUDENTS.  
(B) - ASSUMING A CONSTANT RATIO FROM JANUARY 1977 BE-  
TWEEN THE IMF EFFECTIVE EXCHANGE RATE AND  
THE \$ RATE. END SUMMARY.

1. THE GROWTH OF GDP IS PUT AT 0.9 PERCENT IN 1977 & 1.3 PER-  
CENT IN 1978 COMPARED WITH THE NOVEMBER FORECASTS OF 1.7  
PERCENT AND 0.2 PERCENT RESPECTIVELY. THE REVISIONS IN  
THE 1977 FORECAST ARISE FROM THE DECLINING PROSPECTS FOR A  
STRONG RESURGENCE IN PRIVATE INVESTMENT AND A LESS CHEER-  
FUL VIEW OF THE U.K.'S INTERNATIONAL COMPETITIVENESS,  
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WHILE NO PARTICULAR FACTORS ARE CITED FOR THE 1978 RE-  
VISIONS.

SUMMARY OF GDP ESTIMATES AND FORECASTS  
1976 1977 1978  
POUNDS MILLIONS PERCENT PERCENT  
1970 PRICES GROWTH GROWTH  
GDP(A) 47,778 0.9 1.3  
PRIVATE CONSUMPTION 35,571 -0.6 1.2  
PUBLIC CURRENT EXPEN-  
DITURE 11,122 -0.2 -1.1  
GROSS FIXED INVEST-  
MENT 9,531 -2.5 1.0  
EXPORTS OF GOODS AND  
SERVICES 15,129 5.4 3.6  
STOCKBUILDING -340 (B) (B)  
IMPORTS OF GOODS AND  
SERVICES 14,353 3.2 3.1  
ADJUSTMENT TO FACTOR  
COST 8.882 -0.3 2.0

(A) - COMPROMISE OF EXPENDITURE PRODUCTION AND  
INCOME ESTIMATES. THE DISCREPANCY BETWEEN THE EX-  
DITURE AND THE COMPROMISE ESTIMATE HAS BEEN ATTRI-  
BUTED TO STOCKBUILDING.

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(B) - PERCENTAGE CHANGE IN STOCKBUILDING CONSIDERED TO  
BE A MEANINGLESS CONCEPT.

2. THE FORECASTS ARE PREDICATED UPON CURRENT ECONOMIC  
POLICIES. POLICY ASSUMPTIONS INCLUDE A PAY AGREEMENT GIV-  
ING A 12 PERCENT INCREASE IN EARNINGS IN THE STAGE 3 IN-  
COMES POLICY, AN 800 MILLION POUND INCOME TAX REDUCTION IN  
THE FORTHCOMING BUDGET AND AN EXCHANGE RATE THAT RISES  
FROM FOURTH QUARTER 1976 LEVEL OF \$1.65 TO \$1.72 IN 1977  
IV AND \$1.77 IN 1978 III MONETARY POLICY IS ASSUMED TO  
RESULT IN A DOWNWARD DRIFT IN INTEREST RATES THROUGHOUT  
1977. THE DECLINE HALTING AT AN UNSPECIFIED LEVEL IN 1978.

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3. GROWTH IN CONSUMER PRICES IS ANTICIPATED TO FALL FROM 14 PERCENT IN 1977 TO 8 PERCENT IN 1978. THE ASSUMED GROWTH IN EARNINGS UNDER THE INCOMES POLICY (THE STAGE III YEAR RUNS FROM AUGUST 1 - JULY 31) RESULTS IN A NOMINAL GROWTH OF AVERAGE EARNINGS FROM 9.6 PERCENT IN THE CAL- ENDAR YEAR 1977 AND 11.4 PERCENT IN 1978. THE SAVINGS RATIO IS SET AT 10-1/4 PERCENT IN BOTH 1977 AND 1978. SO REAL PERSONAL DISPOSABLE INCOME FOLLOWS FROM THE GIVEN UNEMPLOYMENT LEVELS. NIESR DOES NOT EXPLICITLY ACCOUNT FOR THE USUAL FEEDBACK OF CHANGES IN CONSUMER EXPENDITURE ON CHANGES IN DISPOSABLE INCOME. THE RESULTING GROWTH IN CONSUMPTION IS A MAJOR FACTOR IN 1978'S ACCELERATED GDP GROWTH.

4. THE CURRENT ACCOUNT WITH A SURPLUS OF 366 MILLION AND 2.2 BILLION POUNDS RESPECTIVELY IN 1977 AND 1978 IS STILL SEEN MORE OPTIMISTICALLY THAN BY OTHER FORECASTERS, BUT THE FORECASTS HAVE BEEN MARKEDLY REDUCED FROM THE 1977 SURPLUS OF 1.1 BILLION POUNDS AND THE 1978 SURPLUS OF 5.0 BILLION POUNDS THAT WERE PUT OUT IN NOVEMBER. THE REVISION IS ATTRIBUTED TO NIESR'S ALTERED IMPORT PRICE EXPECTATIONS. THIS FOLLOWS. IT IS STATED. "THE GOVERNMENT'S EXPRESSED INTENTION TO MANAGE THE EXCHANGE RATE SO AS TO PRESERVE COMPETITIVENESS (WHICH MEANS) THAT UPWARD PRESSURE ON THE EXCHANGE RATE IS LIKELY TO EMERGE AS THE MOVE INTO SURPLUS TAKES PLACE AND IS RESISTED; COMPARED WITH OUR NOVEMBER FORECAST THIS MEANS THAT BY THE END OF 1978 OUR PREDICTED EXCHANGE RATE IS SOME 2 PERCENT LOWER WITH CORRESPONDINGLY LESS FAVORABLE TERMS OF TRADE."

## BALANCE OF PAYMENTS(A)

1976 1977

VISIBLE TRADE 1975 ESTIMATE FORECAST 1978

IMOORTS 21,972 28,044 32,237 33,688

EXPORTS 18,768 24,434 29,930 32,734

BALANCE -3,204 -3,611 -2,307 -954

SERVICES

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IMPORTS	6,275	7,425	8,534	9,147
EXPORTS	7,334	9,115	10,972	12,369
BALANCE	1,059	1,690	2,438	3,223
PROPERTY INCOME	949	1,174	1,110	940
TRANSFERS	-460	-779	-875	-1,000

BALANCE OF

INVISIBLES	1,548	2,085	2,673	3,163
CURRENT BALANCE	-1,656	-1,526	366	2,209

VOLUME, POUNDS MILLIONS 1970 PRICES

IMPORTS

GOODS	9,959	10,643	10,910	11,201
SERVICES	3,607	3,710	3,897	4,064

EXPORTS

GOODS	9,877	10,705	11,133	11,389
SERVICES	4,356	4,424	4,821	5,144

AVERAGE VALUES, 1970 EQUALS 100

IMPORTS

GOODS	220.6	263.5	295.5	300.8
SERVICES	174.0	200.1	219.0	225.1

EXPORTS

GOODS	190.0	228.9	268.9	287.4
SERVICES	168.4	206.0	227.6	240.4

TERMS OF TRADE. GOODS

RATIO OF AVERAGE

VALUES	86.1	86.6	91.0	95.5
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RATIO OF PRICES

(B)	80.8	79.9	81.0	83.5
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(A) - ALL FIGURES IN POUNDS MILLION.

(B) - BASE WEIGHTED (EXCLUDES EFFECT OF CHANGING TRADE  
IN OIL).

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INFO AMEMBASSY BONN  
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5. NIESR DISCUSSES IN DETAIL CERTAIN ASPECTS OF THE ECONOMY WHICH IT FEELS ARE OF CENTRAL IMPORTANCE TO CURRENT ECONOMIC POLICY. IT FINDS FAULT WITH THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) TARGETS ON SEVERAL GROUNDS. FIRST PSBR TARGETS LIMIT THE TAX CUTS THAT CAN BE USED IN TRADE FOR A TIGHT PAY POLICY. SECOND PSBR IS POORLY CORRELATED WITH THE GROWTH OF M3. THIRD, A "FULL EMPLOYMENT" PUBLIC SECTOR BORROWING REQUIREMENT SHOULD BE THE RELEVANT POLICY TARGET IF ONE ACCEPTS BUDGET DEFICIT TARGETS AT ALL. SUCH A CONCEPT WOULD GIVE A BETTER INDICATION OF THE FISCAL POLICY PRESSURE DURING CYCLICALLY DEPRESSED PERIODS. NIESR ESTIMATES THE FULL UNCLASSIFIED

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EMPLOYMENT PSBR TO BE ON THE ORDER OF 5.9 BILLION POUNDS IN THE 1976/77 FINANCIAL YEAR AND TO FALL TO ZERO IN THE 1977/78 AND 1978/79 FINANCIAL YEARS.

NIESR TRIES TO MEASURE THE EXCESS CAPACITY OF INDUSTRY TO JUDGE THE INFLATION PRESSURE OF AGGREGATE DEMAND. IT SURVEYED 67 FIRMS ON THE POTENTIAL GROWTH IN OUTPUT OBTAINABLE UNDER THREE ASSUMPTIONS ON MANPOWER UTILIZATION. THE RESULTS WERE:

	POTENTIAL INCREASES IN OUTOUT AVERAGES. WEIGHTED BY EMPLOYMENT	WITH PRESENT	WITH ADDITIONAL	WITH ADDITIONAL HOURS
FOOD, DRINK AND TOBACCO	11.0	11.0	15.5	15.5
CHEMICALS	16.9	18.2	19.5	33.6
MECHANICAL ENGINEERING	13.6	21.5	35.0	11.5
MOTORS	1.4	6.7	33.6	7.4
METALS	6.0	10.6	11.5	13.0
TEXTILES	7.4	13.0	18.8	15.0
CLOTHING AND FOOTWEAR	20.8	24.5		20.8
PAPER AND PRINTING	13.4	22.4	28.3	14.9
CONSTRUCTION	22.2	36.0		22.2
TOTAL(A)	7.6	12.4	21.5	14.9

(A) - THE TOTAL INCLUDES ALL THE LISTED INDUSTRIES,

WHICH COVERED 76 PERCENT OF THE REPLIES RECEIVED. PLUS OTHER INDUSTRIES WHICH WERE NOT ISOLATED ON GROUNDS OF CONFIDENTIALITY ARISING FROM SMALL SAMPLE SIZE. THE SAMPLE EXCLUDES GAS, ELECTRICITY AND WATER. AND DISTRIBUTION.

FIRMS IN THE SURVEY INDICATED THAT THE PRIMARY CONSTRAINT TO INCREASING OUTPUT WAS DEMAND, ALTHOUGH A NUMBER OF FIRMS CITED DIFFICULTIES OF RECRUITING SKILLED LABOR. SUCH RESULTS ARE BROADLY IN AGREEMENT WITH THE RECENT CONFEDERATION OF BRITISH INDUSTRIES SURVEY. A DISCUSSION OF THE MEASUREMENT OF FULL EMPLOYMENT CONCLUDES THAT ANY EROSION IN THE NUMBER OF MEN OUT OF WORK AT FULL EMPLOY-  
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MENT WAS SMALL IN COMPARISON TO THE CURRENT LEVEL OF UNEMPLOYED. NIESR CONCLUDES THAT THERE IS SUBSTANTIAL SCOPE FOR EXPANSION IN THE ECONOMY, WITH CURRENT GDP STANDING 10 PERCENT BELOW ITS FULL EMPLOYMENT LEVEL.

6. NIESR'S APPRAISAL OF THE U.K.'S CURRENT ECONOMIC CONDITION STRESSES THE NEED TO ACHIEVE A TIGHT THIRD STAGE OF INCOMES POLICY AS THE MOST EFFECTIVE ANTI-INFLATION MEASURE AVAILABLE. IT IS FELT THAT THE PSBR CEILING IN THE IMF LETTER OF INTENT CAN BE COMFORTABLY MET. IT IS ALSO FELT THAT THE PAY POLICY IS OF SUCH IMPORTANCE THAT IT IS WORTH TAKING RISKS ON BREAKING THE PSBR CEILING IF A LOW BASIC NORM FOR THE INCOMES POLICY CAN BE ASSURED THEREBY.

ON THE INTERNATIONAL SIDE. THE FORECAST SURPLUS ON THE CURRENT ACCOUNT LEADS NIESR TO EXPECT UPWARD PRESSURE ON THE EXCHANGE RATE; THE GOVERNMENT IS ENJOINED TO RESIST THIS PRESSURE AS FAR AS POSSIBLE IN ORDER TO MAINTAIN EXPORT COMPETITIVENESS.

IT IS ASSERTED THAT JAPAN AND GERMANY SHOULD BE COMPELLED TO REFLATE THEIR ECONOMIES. IF ORDINARY PRESSURE FAILS, "THE PERMISSIBILITY OF DISCRIMINATION AGAINST THE EXPORTS OF PERSISTENT SUSPLUS COUNTRIES SHOULD BE EXAMINED."

THE AIR OF THE APPRAISAL IS. HOWEVER, THAT NIESR CAN-NOT FULLY RECONCILE THE STATE OF THE ECONOMY WITH THEIR ANALYTIC OR NARRATIVE THINKING. "ALL ELSE ASIDE, WE SEE THE SITUATION IN THE U.K. ECONOMY .- NOT FOR THE FIRST TIME -- AS ONE IN WHICH EXTRA OUTPUT IS NEEDED TO INCREASE EMPLOYMENT. AND EXTRA OUTPUT IS NEEDED TO INCREASE NET EXPORTS, YET WE DO NOT KNOW HOW TO MARRY THE TWO. INCREASING DOMESTIC DEMAND WORSENS THE BALANCE OF PAYMENTS. REDUCING DOMESTIC DEMAND FURTHER INCREASES THE UNEMPLOYMENT OF RESOURCES. AND FAILS TO DIVERT THEM INTO NET EXPORTS IN THIS SITUATION IT SEEMS PARTICULARLY IM-

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PORTANT TO IMPROVE INDUSTRIAL PERFORMANCE. . . ALTHOUGH  
THIS IS, OF COURSE, A LONG RATHER THAN A SHORT-TERM  
POLICY .

7. COMMENT:

NIESR'S REVIEW PROVIDES VALUABLE ANALYSIS OF CURRENT  
U.K. ECONOMIC PROBLEMS. THERE ARE, HOWEVER, SEVERAL  
THEORETICAL AND PRACTICAL POINTS ABOUT WHICH QUESTIONS  
MIGHT BE RAISED.

THE PROJECTED RISE OF STERLING, REACHING \$2.00 IN 1981  
DOES NOT TAKE INTO ACCOUNT A REASONABLY WELL KNOWN PHE-

NOMENA IN INTERNATIONAL FINANCIAL ADJUSTMENTS. IT IS  
POSSIBLE FOR THE DIRECTION OF TRANSITORY EXCHANGE RATE  
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MOVEMENTS TO BE OPPOSED TO THAT OF THE LONG-TERM MOVEMENT  
SIMPLY AS A MATTER OF THE COMPLEXITY OF THE SYSTEM, EVEN  
IF THERE ARE NO EXOGENOUS FORCES PRODUCING THE TRANSITORY  
MOVEMENTS. IN PARTICULAR, FALLING INTEREST RATES, GENER-  
ATING CAPITAL INFLOWS -- EITHER RECORDED, OR UNRECORDED  
AS FOR EXAMPLE THE LEADS AND LAGS OF TRADE SETTLEMENT --  
MAY SUPPORT THE EXCHANGE RATE, EVEN THOUGH IN THE LONG  
RUN LOWER INTEREST RATES WILL INDUCE AN OUTWARD CAPITAL  
MOVEMENT. SIMILARLY, THE EXPECTATION THAT EXCHANGE RATE  
MOVEMENTS REFLECT RELATIVE INFLATION RATES ARISES FROM  
LONG-TERM CONSIDERATIONS.

NIESR'S REVISION OF THE CURRENT ACCOUNT FORECASTS  
FROM THE NOVEMBER LEVELS IS ATTRIBUTED TO A CHANGE IN THE  
OUTLOOK FOR THE U.K.'S TERMS OF TRADE WHICH IN TURN IS  
ATTRIBUTED TO CHANGES IN THE OUTLOOK FOR STERLING OVER  
THE NEXT TWO YEARS. THE STATISTICS PRESENTED DO NOT, HOW-  
EVER, SUPPORT SUCH A LINE OF CAUSATION. THE EFFECTIVE EX-  
CHANGE RATE WAS SET AT:

	1976	1977	1978
NOVEMBER REVIEW	66.3	60.7	64.0
FEBRUARY REVIEW	66.3	62.6	63.9

THE DIFFERENCES, ESPECIALLY IN 1978, ARE SO SMALL THAT  
WHATEVER ONE'S THOUGHTS ON INVOICING AND PRICING POLICIES.  
THE TERMS OF TRADE REVISIONS CANNOT BE JUSTIFIED ON THE  
BASIS OF EXCHANGE RATES. THE TERMS OF TRADE ARE MOST  
LIKELY TO HAVE SHIFTED AS A RESULT OF A MODEST REASSESS-  
MENT OF THE IMPACT OF NORTH SEA OIL. IN THE NOVEMBER  
REVIEW THE INDEX OF THE TERMS OF TRADE CLIMBED SHARPLY  
UPWARD IN 1977 AND 1978. (SEE REF B) THIS CLIMB BASIC-  
ALLY RESULTED FROM AN ODD CONSTRUCTION OF THE INDEX WHICH  
MADE IT VERY SENSITIVE TO CHANGES IN THE VOLUME OF OIL  
IMPORTS. NIESR HAS CALCULATED A NEW, BASE-WEIGHTED IN-  
DEX THAT IDEALLY DOES NOT REFLECT SUCH VOLUME MOVEMENTS.  
THE OLD INDEX, NOW MORE APPROPRIATELY TITLED THE "RATIO  
OF AVERAGE VALUES." HAS BEEN REVISED DOWNWARD.

THE FULL EMPLOYMENT PUBLIC SECTOR BORROWING REQUIRE-  
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MENT. HAS SEVERAL FLAWS THAT ARE NOT DISCUSSED IN THE RE-  
VIEW. THE PSBR CONTAINS EXPENDITURE AS WELL AS FINANCIAL  
TRANSACTIONS DATA. SO COMPUTING ITS FULL EMPLOYMENT LEVEL  
REQUIRES A REASONABLY COMPLEX MODEL INTEGRATING

THE FINANCIAL AND REAL SECTORS OF THE ECONOMY. NIESR DOES NOT HAVE SUCH A MODEL, AND IN FACT "DOES NOT WEIGHT THE COMPONENT ELEMENTS OF RECEIPTS AND EXPENDITURE BY THE RELATIVE DEMAND COMPONENTS., LACKING SUCH WEIGHTS FULL EMPLOYMENT BUDGETARY MEASURES MAY NOT MAKE SENSE.

THE MEASURES OF IDLE CAPACITY AND OF THE SLACK CURRENTLY PRESENT IN THE ECONOMY IGNORE TWO IMPORTANT QUALIFICATIONS. FIRST THE SURVEY DID NOT TAKE PRICES INTO ACCOUNT. RELATIVE PRICES HAVE BEEN EXERTING SOME INFLUENCE IN FACT. FOR EXAMPLE. THE SURVEY POINTS OUT THAT THERE HAS APPARENTLY DEVELOPED A SHORTAGE OF SKILLED STAFF, WHICH ONE MUST PRESUME ARISES FROM SHIFTS IN DEMAND AWAY FROM UNSKILLED WORKERS INCIDENT UPON THE COMPRESSION OF PAY DIFFERENTIALS BY THE INCOMES POLICY.

OVERCOMING CONSTRAINTS TO PLANT EXPANSION MEANS THAT COSTS ARE INCURRED. AND SO IT IS NOT MEANINGFUL TO ASK THE SIZE OF POTENTIAL OUTPUT GROWTH WITHOUT SPECIFYING SOME CONFIGURATION OF PRICES. SECOND, THE MEASURES, IN SIMPLY AVERAGING THE RESPONSE OF FIRMS, IGNORE THE INPUT-OUTPUT STRUCTURE OF AN ECONOMY. THAT IS TO SAY. IF THE ACTIVITIES OF A FIRM PRODUCING A VITAL GOOD ARE RESTRICTED, THEN THE ACTIVITY OF FIRMS USING THE GOOD WILL BE RESTRICTED EVEN IF THE USING FIRMS FEEL THAT LABOR CONDITIONS ARE QUITE LOOSE.

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## Message Attributes

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